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International Economic & Energy Weekly

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4 January 1985

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**International
Economic & Energy
Weekly**

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4 January 1985

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**International
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Synopsis

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Perspective***LDC Economic Challenges in 1985***

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Last year was in many ways a transitional one for Third World economies. Two important positive trends emerged. Exports—buoyed in large part by the growing appetite of the US economy for imported goods and services—increased by some 6 percent, and, for the non-OPEC LDCs, surpassed the 1981 peak. Concurrently, the critical atmosphere of the debt negotiations waned, with Mexico, Venezuela, and Ecuador obtaining multiyear restructurings, Brazil apparently on its way to one, and Argentina, after several bouts of brinksmanship, reaching an IMF accord.

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The LDC economies, however, are far from out of the woods:

- Imports and living standards remain depressed, with LDC imports down an estimated 20 percent from 1981, and real per capita output off 2 percent; in Latin America, real per capita output has fallen 12 percent in three years.
- The drought in Africa has intensified problems in a number of already poor countries—notably Ethiopia, Chad, Niger, Mali, Sudan, Kenya, and Mozambique. In those countries, some 14-20 million people face starvation; the situation will not improve until 1986 at the earliest.

Due to the economic dislocation caused by debt problems, drought, and economic mismanagement, most observers expect it will be the end of the decade before most LDCs regain even 1980 living standards.

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Attempts to deal with the problems imposed by external economic constraints have themselves generated problems. Inflation in the Third World has hit unprecedented levels, with several countries experiencing triple-digit inflation and one—Bolivia—facing four-digit price increases. Devaluations, import stringencies, and, in some countries, explosive monetary expansions have all contributed to the surge in prices. Political strains also have been made worse by the economic problems. To date, these strains have been manageable, and economic problems alone are unlikely to create major political crises in 1985. Nevertheless, some governments—notably the Philippines, Peru, and Bolivia—will be under especially severe political-economic pressure this year.

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We believe that, while continued OECD economic growth will be of great benefit to the LDCs, they themselves must undertake a number of structural, longer run adjustments to turn their difficult situation around:

- Ways must be found to replace the possible permanent loss of \$20-30 billion annually in commercial bank lending that the LDCs used to fuel growth in the 1970s. Foreign direct investment is often mentioned as a possibility, but

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the outlook there is mixed. Some LDCs are taking steps to make foreign investment more desirable for Western companies, but others, including some key debtors, are going in the opposite direction. In many countries, poor general economic conditions will make foreign investment unattractive for a number of years, and it is almost impossible to expect a rise in foreign investment—which recently totaled only \$10 billion—large enough to offset the drop in commercial bank funds.

- Adjustments also are needed to spur growth from domestic resources. The reluctance to take necessary structural adjustments is well known, but, beyond that, increases in LDC domestic saving and investment to finance structural adjustments and offset declines in foreign capital sources seem unlikely. If anything, domestic LDC savings rates are lower than they were in the late 1970s.
- In the famine-affected African countries, fundamental changes in food policies are needed, but we are not optimistic that this will occur. We believe a major cause of the Ethiopian famine is the policies of the Mengistu regime, and even in the other countries the priorities of the governments work against meaningful agricultural reform and development. [REDACTED]

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The lack of structural adjustment puts the LDC economies at risk to adverse shifts in the world economy. A particularly likely risk this year could be an OECD growth slowdown. The rise in LDC exports of more than \$30 billion in 1984 was heavily driven by robust OECD economic growth of 4.8 percent. This year, observers expect OECD growth to slow to 3 percent. If LDC export growth declines proportionately, LDC foreign sales will rise by under \$20 billion, creating the need for greater foreign borrowing or import reductions than was necessary last year. The former may not be available; the latter would be politically difficult. [REDACTED]

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Among debtor countries, the so-called second-tier debtors may be the most vulnerable. These countries, such as Egypt, the Philippines, Indonesia, and Peru, have large debt burdens, possess relatively fewer economic resources to cope with needed structural changes, and in some cases have just begun their adjustment processes. Moreover, because their debts are individually small, bankers may be less willing to deal with them as they did with big debtors. Consequently, despite the seeming improvement in the debt situation, the probability remains that one or more of these smaller debtors may experience a debt crisis this year similar to that experienced by the larger countries in the past three years. [REDACTED]

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Briefs

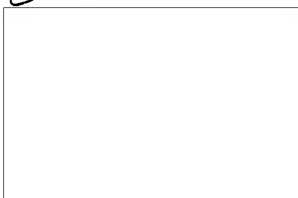
Energy

OPEC Meeting Results

OPEC has unanimously agreed to establish a high-level committee to monitor members' compliance with production and pricing policies, but Algeria and Nigeria have balked at the organization's pact to realign the differential between its light and heavy crude oil prices. The new monitoring committee's lack of power to enforce production guidelines will leave the door open for continued cheating and reinforces market skepticism that OPEC can control oil prices. The small adjustments of crude prices around OPEC's benchmark price of \$29 per barrel do not accurately reflect market conditions and will keep pressure on some producers of light crude to discount prices further. OPEC will need a rebound in oil demand and a strong commitment to production quotas if it hopes to avoid a price decline in the coming months.

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*Tankers Refuse
To Enter
Iranian War Zone*

Several tankers have refused to call at Iran's Khark Island oil terminal because of the increased Iraqi air attacks. In the past week, officers and crew of at least one ship asked to disembark rather than go to Khark, and the Norwegian ship owners association barred Norwegian-flag tankers from the Iraqi-declared war zone. Since the resumption of Iraqi attacks on 3 December, the maximum war-risk premium for tankers going to Khark has tripled, and cargo insurance has quadrupled. The combined effect has raised the cost of insuring Iranian crude from \$1.30 to almost \$3.00 per barrel. Sustained Iraqi attacks probably will force Iran to lower its price to maintain exports at current levels. For the right price, most shipowners will still be willing to risk loading at Khark.

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*Saudi
East-West
Oil Pipeline Expansion*

Riyadh is proceeding rapidly with preparations for a pipeline parallel to the existing East-West Petroline to the Red Sea, according to a State Department source. The Saudi pipeline will provide greater security for some Saudi oil exports and oil supplies to refineries on the Saudi west coast and could make additional export capacity available for Iraqi crude to Yanbu al Bahr. Money for the \$900 million, 56-inch-pipeline project was approved by the Saudi oil company in November. Construction could begin as early as May, with completion possible by late 1986, according to the US Consulate in Dhahran. The new pipeline will at least double capacity to 3.7 million barrels per day for export at Yanbu al Bahr or use in west coast Saudi refineries. Another State Department source indicates that the Saudis, meanwhile, are continuing to delay approval for the proposed Phase II of the Iraqi-Saudi project, which calls for an Iraqi pipeline paralleling Petroline.

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*Malaysia Cuts
Oil Production*

Malaysia last week announced plans to cut 1985 oil production to 410,000 barrels per day—a 7-percent drop from the 1984 level—to support OPEC's efforts to stabilize oil prices. Although the production cut is relatively small, it represents the first time Malaysia has taken such action. Malaysia attended the yearend OPEC meeting for the first time as an observer. Kuala Lumpur's willingness to cut production may also reflect an easing of its recent foreign payments problems. The 1984 current account deficit of \$2 billion represents more than a one-third improvement from the 1983 deficit. Moreover, the US Embassy believes Malaysia may also be having trouble locating buyers for its high-quality, high-priced crude.

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International Finance

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*Moroccan Financial
Negotiations*

Morocco's negotiations to reschedule its commercial bank debt for 1984 are again on hold, according to the US Embassy in Rabat. As a result, talks with the World Bank, the IMF, and official creditors scheduled for early this year to discuss additional debt relief probably will be delayed. Morocco needs a multiyear debt-rescheduling agreement soon to ease the estimated \$2.5 billion debt service burden in 1985—two and a half times the level in 1984. The commercial banks have backed off from their demand for a Central Bank guarantee of debt payments, but are insisting on an IMF-backed austerity program. Morocco's budget for 1985 includes some cuts in education and other social programs, but the adjustments are too limited and poorly focused to meet Fund-recommended budget deficit targets. Moroccans are increasingly concerned over likely additional declines in living standards and may again take their frustrations to the streets as they did in January 1984.

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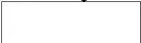
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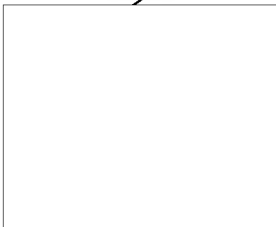
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Global and Regional Developments*EC-Spanish
Accession Talks
Make Progress*

Spain moved one step closer to joining the European Community late last month, when negotiators reached agreement on postaccession restructuring of the Spanish steel industry and dismantling of Spain's high tariffs on industrial products. The steel agreement allows Spain to continue subsidies to its domestic industry for three years following accession but will require EC Council approval beyond that period. Spanish steel shipments to current EC members will be limited during the three-year transition to 827,500 metric tons for the first year, with limits for subsequent years to be negotiated later. Tariffs on industrial products will be gradually reduced to the level of the EC's common tariff over seven years. Auto exports to Spain from EC countries will be subject to a three-year quota rising from 32,000 units to 40,000 units. These agreements remove a major obstacle, but more difficult hurdles remain, including agriculture and fishing rights, which may threaten to delay entry until well after the scheduled 1 January 1986 accession date. 

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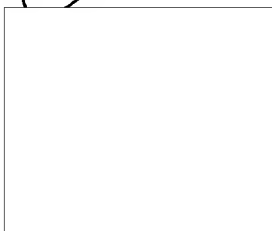
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*West German
Push for North-South
Round*

A West German Foreign Ministry official told US diplomats that his government would like the 1985 Bonn economic summit to build momentum toward a high-level North-South conference similar to the 1981 Cancun summit. He stressed, however, that the call for such a conference should come from Mexico and Austria, which proposed Cancun. The official believes the Cancun meeting helped give the North-South dialogue a more positive tone by taking it out of UN forums. He said the Foreign Ministry hopes to flesh out a proposal for the summit preparatory meeting scheduled for February. Japan, France, and Italy are likely to be receptive to the idea of a high-level North-South meeting. At previous economic summits, they have urged the United States to give political impetus to the North-South dialogue, even though they did not intend to make substantive economic concessions to the developing countries. 

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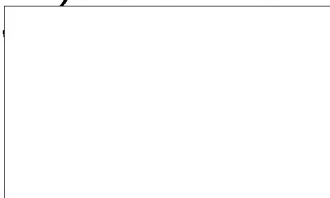
National Developments*Developed Countries**Increase in
Japanese Defense
Spending*


The Japanese Cabinet last week approved a 6.9-percent increase in defense spending for FY 1985. Prime Minister Nakasone struck a compromise between the initial Defense Agency's target of 8.6 percent and the Finance Ministry's target of 5.1 percent. Defense spending next year will total \$12.55 billion, just under the 1-percent-share-of-GNP limit. The US-Japanese summit this week undoubtedly influenced Nakasone's decision to push for an increase over the 6.55-percent rise of last year. The opposition parties will attack Nakasone when the Diet resumes in January, both for the defense increase at a time of overall budget austerity and for the near breach of the 1-percent defense spending ceiling. 

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*Italian
Current Account
Deteriorates*

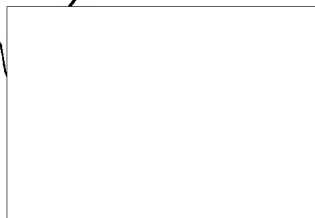



A sharp deterioration in the Italian current account in the second quarter resulted in a cumulative January-June 1984 deficit of \$1.3 billion on a seasonally adjusted basis, compared with a \$800 million surplus over the same period in 1983. Italy's worsened position primarily reflects a steep runup in the trade deficit as economic recovery caused imports, particularly energy products, to outpace export gains in both volume and value. Limited recovery in key EC markets and weak demand in LDC markets were largely responsible for limiting export gains to 15 percent. Sales to the United States, however, were a bright spot, up 62 percent, as exporters took advantage of the weak lira to increase their market share. With the trade imbalance in the July-October period showing a continued, albeit slower, rise, and a moderate improvement on the invisibles account likely, the current account deficit for the year will probably total about \$1.3 billion, compared with a surplus of about \$800 million in 1983. 

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*French Unions
Balk at Labor Accord*

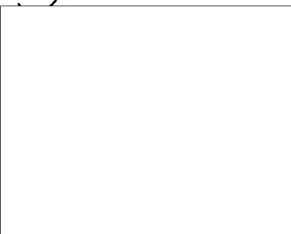



French unions have decided not to sign the agreement they had initialed with the employers' association in mid-December, after seven months of negotiations. Aimed at easing labor market rigidities, the accord would have reduced the period necessary to authorize layoffs, increased the ability of firms to use temporary workers, and postponed the tax and social insurance burdens firms face when they cross certain staffing thresholds. The Communist-dominated CGT had refused to initial the agreement from the outset and succeeded in provoking vehement rank-and-file objections, which caused the other unions to reverse themselves. Having failed in this collective bargaining, the government will find it difficult to reduce employment barriers by administrative action. At a minimum, however, it probably will speed up the layoff process and reduce threshold charges that make it expensive for small firms to expand. 

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*Austria Aiming
To Imitate
Silicon Valley*

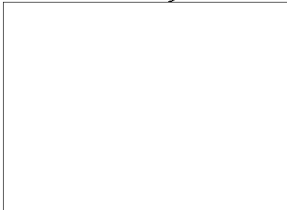


The Austrian Government is helping to set up technology parks and venture capital funds to promote small, high-tech businesses. Vienna's approach is to create complexes with easy access to universities and other research centers where new businesses can share clerical help and lab space. The technology parks will have staffs on hand to provide business advice and to help entrepreneurs make contacts. The first new venture capital fund will start this month with mostly private funding. The first park will be in business in Vienna in about a year, with future centers slated for Salzburg, Linz, and Graz. Although the parks will be government funded, Vienna hopes that they will eventually be self-sufficient. Key features of Austria's economy, however, work against innovation: the large government role; the preponderance of heavy, traditional industry; risk-averse businessmen and bankers; and lack of interchange between research universities and business. 

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*Less Developed Countries**Nigeria Struggles
With Oil and Debt*

Debt service payments will consume 36 percent of Nigeria's estimated \$11 billion oil earnings for 1984, according to the US Embassy in Lagos. Production this month has risen to 1.7 million barrels per day, about 400,000 barrels per day more than the OPEC quota. Nevertheless, revenues have not increased proportionately because of lower official prices, some discounting, and the inclusion of lower priced, heavier crudes in contract sales. [REDACTED]

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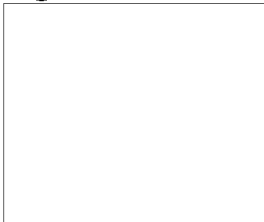
[REDACTED] Lagos will react to any price reductions by the United Kingdom and Norway by trying to maintain at least a 50-cent-per-barrel advantage over North Sea oil. [REDACTED]

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Nigeria is desperately short of cash and probably is trying to sell as much oil as possible during the final quarter of 1984 in anticipation of continued downward pressure on prices. The burden of larger debt payments due in 1985 and declining oil earnings would force the government to cut back even further on imports, thus increasing inflation, unemployment, and shortages of goods. The regime already is under pressure from almost daily rumors of an impending coup or Head of State Buhari's resignation, and the 1985 budget is likely to be unpopular. [REDACTED]

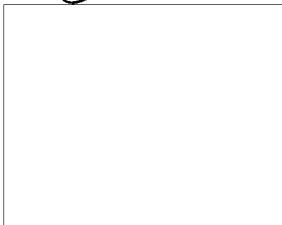
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*Mexican Inflation
Problems in 1985*

Mexico is unlikely to meet its inflation target this year as the government focuses on promoting economic growth rather than on slowing price increases. We believe inflation for 1985 will be near 50 percent, substantially above the government's target of 35 percent. While slow money supply growth before August had helped harness rising prices, the money supply grew rapidly in the last few months as the government sought to finance the public-sector deficit and foreign reserves mounted. In keeping with its pledge to end the fall in real wages, Mexico City also announced a 30-percent hike in the minimum wage. Another is expected at midyear. Meanwhile, reduced food subsidies and higher gasoline and utility prices will add to inflationary pressures. [REDACTED]

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Mexican Gas Explosion

The 19 November explosion that ripped through the PEMEX liquid petroleum gas storage facility—Mexico City's largest—was the worst industrial disaster in Mexican history. The blast at the PEMEX installation is known to have killed more than 490 people, injured more than 4,200, and left some 900 missing and 10,000 homeless. The final death toll may exceed 1,500. The accident was possibly the result of a lack of standard safety features, such as gas detectors either not in place or inoperative. The Mexican Attorney General has officially blamed the incident on a massive gas leak at the PEMEX facility, and ordered the state-owned company to compensate the victims. About \$2.3 million in claims have already been filed. Mexico City has responded to public pressure to relocate dangerous facilities by taking steps to increase safety measures at PEMEX and naming a commission to study potential urban disasters. The debt-strapped Mexican Government, however, is unlikely to move any facilities, because of the enormous expense. The estimated cost is \$10 billion to move the plants from Mexico City alone. [REDACTED]

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*Libyan Agricultural
Sector Shakeup*

Qadhafi has dismissed several key figures in the Ministry of Agriculture and other related sectors of the government over the past two months because of sharp setbacks in agricultural production. []

[] these dismissals also may be aimed at curtailing private enterprise activities by bureaucrats. Overall agricultural production probably dropped by 10 percent last year because of inept government management and financial stringency. Spare parts are often in short supply or delayed by customs and distribution problems. As a result of the soft oil market, no new agricultural projects have been completed since 1981. The drop in domestic production, coupled with lower oil revenues since October, has added to shortages of foodstuffs and increased disgruntlement. []

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*Tunisia and Libya
Broaden Economic Ties*

Press sources report that Tunisia and Libya signed new agreements during meetings in Tunis last weekend that call for the elimination of customs duties on national products, coordination of youth programs and education, and security cooperation. Details on the extent of security cooperation are unknown. These accords probably resulted from increasing Libyan pressure designed to disrupt Tunisia's growing relationship with Algeria. Tripoli probably also believes increased economic cooperation will position Libya to exploit political uncertainties in Tunisia when President Bourguiba dies and increase Libyan leverage when the security talks resume. []

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Oman Borrows Abroad

Oman has arranged a \$400 million loan through Arab banks. According to the US Embassy, the funds are needed to help finance Oman's 1984 budget deficit. This is the second consecutive year that Oman has sought external financing to cover budget shortfalls resulting from the lower-than-anticipated oil revenues. Despite the loan, Muscat may have to dip into the \$2.4 billion State General Reserve Fund to cover 1984 expenditures. This special fund was created to sustain the country when oil supplies are exhausted. []

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*Record Pakistani
Cotton Crop*

Preliminary estimates indicate that Pakistan will have a record cotton harvest this year following a disastrous, pest-ridden crop last year. With harvesting half over, about 460,000 metric tons of cotton had been delivered to the ginning factories—almost equal to last year's total. Government officials [] estimate that total production will reach 800,000 to 1 million tons. A bumper cotton crop will provide welcome relief to an economy that last year grew at the slowest rate since President Zia came to power in 1977. An anticipated rebound in raw cotton and textile exports—about 30 percent of Pakistan's total exports—also will give a boost to a deteriorating foreign payments position. []

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*Communist**CEMA Decision
on Pricing*

A Soviet economist has told US Embassy officials that CEMA will continue to set annual trade prices among member countries during the 1986-90 Plan period at a level equal to the average of world prices in the previous five years. The decision was made at the recent CEMA Foreign Trade Commission meeting in Moscow. Reports from the CEMA summit last June had indicated the moving average formula would be replaced by a system that would take more account of current world prices. The Soviets benefit from the five-year average because declining world oil prices affect CEMA prices more slowly. The current formula will help Eastern Europe if world energy prices rise. Besides being consistent with CEMA's aversion to change, maintaining the five-year average satisfies the preferences of the East Germans, Soviets, and other orthodox planners for a predictable pricing mechanism. The apparent losers are the reform-minded Hungarians, who advocate the use of current world prices to improve efficiency.

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*Focus on Soviet
Family Problems*

A recent *Pravda* article by a prominent demographer targets improvements in the quality of family life as a prerequisite for changing "unfavorable demographic patterns." The article is the latest example of a public relations campaign begun in the mid-1970s to strengthen family life after the 1970 census showed a slowdown in the growth of the population, an increasing number of single people, and small families in Slavic areas. Policy since 1981 has been aimed at reversing the falling Slavic birthrate and reducing the high rate of divorce, caused by increasing male alcoholism, early marriage, lack of housing, and unequal sharing of household responsibilities. The regime has also taken a few steps to strengthen family life, including the creation of family counseling centers, an increase in family allowances, paid maternity leave for working mothers, sex education programs in schools, and interest-free housing loans to young families. These efforts may help but are being implemented on a scale too limited to have much impact. Moreover, some elements of Soviet policy continue to undermine efforts to promote family life. The high rate of female labor force participation and inadequate wage scales that virtually compel women to work contribute to a decrease in the birthrate, particularly if child care is difficult to arrange.

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*Chinese Textile
Trade With Japan
May Be Limited*

The Japanese cotton fabric industry plans to ask Tokyo to negotiate a bilateral agreement to limit imports of Chinese cotton fabrics. Such an agreement would be based on the GATT Multifiber Arrangement (MFA), which Beijing joined early last year. According to Japanese trade statistics, China accounts for about 85 percent of Japan's imports of unbleached cotton fabrics. Japan has been trying to reduce imports of these fabrics in favor of cotton yarns for use in domestic weaving mills. China's drive to increase exports has Japanese industrial leaders concerned that low-cost competition will reduce their share of domestic markets. China already has bilateral agreements governing textile trade with most OECD countries, but Japan only negotiates annual import levels of silk products from China.

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Argentina: The Financial Struggle Ahead

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Argentina was able to gain sufficient new lending commitments from its 300 creditor banks in time to allow the IMF to approve a request for a \$1.4 billion standby loan on 28 December. The banks are still about \$400 million short of the \$4.2 billion requested despite considerable efforts by Argentine officials, the steering committee banks, and the IMF to sell the package. We believe, however, that the full amount will be raised in the next few weeks, enabling Argentina to clear its interest arrearages and repay a \$750 million bridge loan. Even so, we foresee financial uncertainties ahead for the government of President Alfonsin. We anticipate that Buenos Aires will be unable to comply with its IMF program this year, especially with promises to keep a lid on wage increases and reduce the public-sector deficit. With an economic recession now brewing and inflation only ebbing slightly, domestic political pressures will test the government's commitment to an austerity program needed to convince creditors to continue disbursements under the agreement. []

Completing the Financial Rescue Package

We believe the financial rescue package probably will be completed over the next several weeks. Although creditors are grumbling, they probably recognize that some new lending is required to protect their existing exposures and prevent the Argentines from threatening to organize a debtors' cartel. Even if some of these bankers refuse to participate, the larger banks may increase their shares of the new loans to complete the negotiations, according to the press. []

If the financing package is approved by February, which we believe likely, Buenos Aires will have enough funds to take care of about \$2.2 billion in public- and private-sector interest arrearages and to repay a \$750 million bridge loan. This money

also will allow Argentina to cover a current account deficit of a little over \$2 billion—the current Argentine and IMF projection for 1985. Moreover, the banks have agreed to reschedule over \$13 billion in past-due loans at interest rates only slightly above those charged for Mexico's rescheduled debt. []

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The Struggle To Maintain IMF Compliance

Even when the financing package is complete, Argentina still faces the considerable task of maintaining compliance with its ambitious IMF program. The memorandum of understanding that went into force on 1 October has as its major goal a sharp reduction of inflation, largely through a cut in the budget deficit. For example, inflation, which in November was running 675 percent over the same month in 1983 is targeted to drop to 150 percent in the last quarter of 1985. This will require Buenos Aires to exercise greater wage restraint and fiscal discipline than last year. []

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Applying Wage Restraint. Buenos Aires' willingness to control public-sector wage increases will play a key role in efforts to hold spending in check. The IMF agreement allows for scheduled monthly wage hikes and occasional supplementary increases to make up for inflationary losses. During the IMF negotiations, the Argentines had given verbal assurances that wages would be increased by no more than 12 percent per month during the October-December period, [] Within days after signing the accord, however, the government announced a 14-percent monthly increase for the last quarter. Concerned that such hikes would threaten compliance with the new program, the Fund recalled Argentine negotiators to Washington, according to the press. []

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Although the issue was temporarily defused, we believe Buenos Aires will face growing demands from civil servants this year for larger wage hikes. The US Embassy reports that real wages for civil servants fell in October and November in the face of inflation rates of 19.3 and 15.0 percent, respectively. In response to increasing pressure from the General Confederation of Labor, Economy Minister Grinspun has announced that in 1985 government workers will receive higher wage increases than last year. Moreover, he has promised a 6- to 8-percent special salary supplement in January, which, if kept, bodes ill for meeting IMF targets. []

Exercising Budget Discipline. Buenos Aires also faces the need to implement budget austerity, mainly by reducing expenditures. To shrink the deficit in the face of declining tax revenues in 1984, according to US Embassy reporting, the government deliberately underfunded spending programs, most notably in the military and nuclear sectors. The government may have used this approach to force these agencies to economize and draw on available cash reserves, but we judge this process has run its course because government agencies have fallen as much as 180 days behind in their payments to suppliers. []

We judge budget disbursements in 1985 probably will have to show some growth just to pay past-due bills, forcing programed spending to be pared to stay within IMF budget targets. The government has promised a draft budget later this month, according to the US Embassy, and we have only fragmentary indications of where Alfonsin will trim. An Embassy source reports that the health and social budgets have already been determined, which suggests that no controversial cuts were made here. Figures leaked by the military, however, indicate that its spending will be cut sharply again—one military spokesman asserts that a 50-percent cut will be made. []

Despite government promises to increase the efficiency of the notoriously leaky tax system, the fall in revenues last year does not indicate progress. Moreover, with recession apparently under way, only the recently increased levies on agricultural

exports promise some gain in the tax take. Without a strong increase in revenues, we judge that the government will miss the budget deficit targets for 1985, even if it is successful in holding down wage increases. []

Beyond this, continued monetary tightening will probably be required to take the steam out of inflation. Since September, government restrictions on intercorporate loans have helped drive interest rates well above inflation. These tighter credit policies have caused firms to repatriate dollars and sell them for pesos to obtain working capital. Businessmen reportedly have become convinced that tight monetary conditions will continue as the government tries to adhere to the IMF program and that the economy is in a recession that will last at least through this spring. We believe that if the government adheres to the IMF monetary targets the downturn could last even longer. []

Foreign Sector Policies. The Central Bank has devalued the peso on a daily basis, with occasional large adjustments to offset surges in domestic prices. By the end of 1984, the peso had been devalued by more than called for in the IMF agreement, which stated that peso devaluations should be sufficient to make up for inflation differentials with Argentina's trading partners. On the basis of trends in Argentine wholesale prices, we judge the real value of the peso is now about 10 percent lower than at the start of 1984, and we expect the government to keep up regular devaluations to comply with the accord. []

Buenos Aires has also agreed to lessen gradually the stringent import controls established last January. The IMF is scheduled to review progress in achieving this goal during the first quarter of 1985. Although business and labor will resist the removal of import barriers, Buenos Aires can help placate these groups by maintaining current devaluation policies. []

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Outlook

We believe the government probably will continue to achieve some success in the first few months of 1985 in staying close to its IMF targets. A slack economy and the onset of the major harvest period with abundant food supplies should keep inflationary pressures down. Moreover, the beginning of the summer vacation period probably will lead to a temporary decline in political pressure to recoup purchasing power through wage increases. [redacted]

Nonetheless, we expect the government in the coming weeks to become increasingly concerned over the weak state of the economy. Businesses will continue to reduce their inventories because of the high costs of financing and weak demand as real wages shrink. We expect the Central Bank to continue to squeeze the credit markets—to fight inflation and attract dollars from overseas—and to continue devaluing the peso in line with what we believe will be declining inflation. Although this combination of policies will encourage exports and improve the current account, it will heighten popular opposition to austerity. [redacted]

By March, when political activity usually regains momentum, we judge the government will come under considerable pressure to grant bigger wage increases and stimulate the economy. The Peronists and the labor unions probably will be quick to assert that IMF-dictated policies are causing increased unemployment and losses in real wages, which they had predicted. The financially pinched military may also begin to ask for budget relief to reverse deteriorating force readiness. Moreover, the business community is likely to become alarmed over high interest rates and slack demand and begin to lobby for some budget stimulus, probably through stepped-up public investment. [redacted]

We believe Alfonsin remains vulnerable to such political pressures. Alfonsin might be able to head off trouble later by admitting now that to bring inflation under control some of his policies will depress the economy in the short run. To do so, he may also have to decree a policy of no real wage increases for 1985. If Alfonsin takes these steps, we believe he would also increase Argentina's chances

of maintaining close enough compliance with IMF targets to obtain waivers from the Fund during the first review in the spring. If, instead, he decides to buy off interest groups, Argentina runs the strong risk of falling so badly out of compliance that future credit tranches will be suspended. With a projected \$2 billion current account deficit this year, another suspension of credit would reignite financial problems. [redacted]

Implications

[redacted]

A halt in credit disbursements would again lead to delays in interest payments for creditors and a major renegotiation of the credit package with unpredictable consequences. Another round of tough negotiations with Buenos Aires may cause bankers to resist providing additional credit to support the financial rescue program. Even if this does not occur, resurgent debt problems would reopen the debate in Argentina about whether international credit obligations deserve to be honored. Under these conditions, any adverse turn of events such as rises in interest rates or decline in growth in the industrial countries would help rebuild support for the debt moratorium option within the ruling Radical party. Although [redacted]

[redacted] the fear of an Argentine debt moratorium has receded considerably, we believe that Argentina could still find support for joint action in nations such as Bolivia, Peru, Chile, and Colombia. [redacted]

[redacted]

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LDC Debtors: Struggling With Inflation

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Spiraling inflation—currently ranging from 60 to 1,600 percent—threatens to stall the recoveries of a number of debt-troubled developing countries. We believe that attempts to cushion the decline in living standards in the face of cutbacks in the growth of foreign lending have played a crucial role in the near-runaway inflation in these countries.

Large budget deficits—a growing share of GDP—have had to be financed by faster money supply growth fueling price increases. Domestic opposition to needed austerity measures has hampered the battle against inflation, promoted capital flight, distorted investment, and imperiled IMF agreements. Prospects for economic growth have dimmed, despite progress in resolving debt problems. In particular, severe chronic inflation seriously troubles governments in Argentina and Bolivia and may contribute to political unrest in Peru and the Philippines. Reversal of the recent downward trend in inflation also could threaten economic recovery and financial adjustment in Mexico.

Accelerating Inflation

Consumer price inflation has become an acute problem in a growing number of developing countries. [] for the nonoil LDCs as a group, GDP-weighted annual inflation rates increased from 25 percent in 1979, to 32 percent in the 1980-82 period, to 44 percent last year. A number of key debtor LDCs have been particularly hard hit. Bolivia leads the list with 1,600-percent inflation for 12 months through October, followed by Argentina with 700 percent. Triple-digit inflation also persists in Brazil and Peru.

Key Debtor Countries: Inflation Rates

Percent ^a

Bolivia (through October 1984)	1,590
Argentina (through October 1984)	704
Brazil (through October 1984)	211
Peru (through August 1984)	104
Mexico (through November 1984)	59
Philippines (through October 1984)	64

^a Percent change over preceding 12 months.

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Underlying Factors

In our view, the inflation spiral now afflicting many LDCs had its roots in the recession of the early 1980s, when many LDCs ran up huge government deficits in an effort to protect living standards. Public-sector expansion often continued into the recession, even as government tax collections fell. In Argentina, for example, government deficits during 1981-83 as a share of GDP were triple those of the preceding four-year period. Substantial deficit increases also burdened the economies of Bolivia, Brazil, Mexico, and the Philippines.

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In many debt-troubled LDCs, neither foreign nor domestic lending could be mobilized in amounts sufficient to cover the ballooning deficits:

- The growth of foreign lending to many developing countries slowed dramatically as lender banks began to question the ability of LDCs to service

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Key Debtor Countries:**Government Deficit as a Share of GDP**

Percent

	1977-80	1981-83
Bolivia	6.0	17.1 ^a
Brazil	7.1	15.6
Mexico	3.1	10.2
Argentina	3.1	9.3
Philippines	1.1	3.3
Peru	3.9	3.9

^a Data available for 1981 and 1982 only.

their accumulating debt.
 new commercial lending to nonoil LDCs fell from
 \$41 billion in 1982 to \$27 billion in 1983.

- Domestic lending could not meet the widening gap between borrowing from abroad and the growing deficits. Economic recession constrained domestic savings, while higher foreign interest rates and overvalued official exchange rates often led to large-scale capital flight. We estimate, for example, that capital flight from Latin American LDCs may have exceeded \$100 billion during 1979-83.

When borrowing could no longer support their government deficits, some debt-troubled LDCs resorted to inflationary financing through substantial increases in the domestic money supply. Particularly sharp accelerations in monetary expansion have occurred in Argentina, Bolivia, Peru, and the Philippines; in each country, money stock growth has nearly tripled since late 1982.

Current Developments

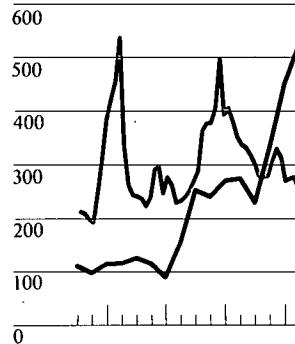
There are few signs that inflation in key debtor countries is likely to abate quickly:

- While Argentina's planned budget deficit would have accounted for 10 percent of GDP in 1984, the reluctance of the government to cut social

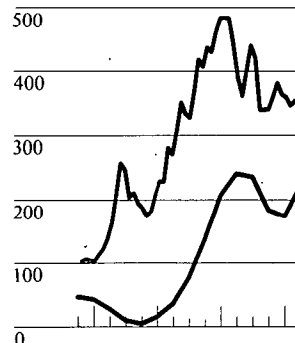
Troubled LDC Debtors: Consumer Price and Money Supply Growth^a

Percent

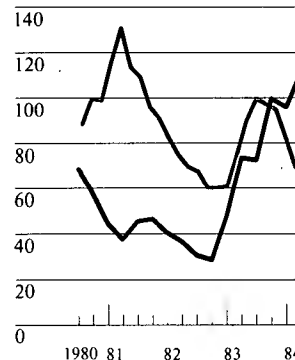
Argentina



Bolivia



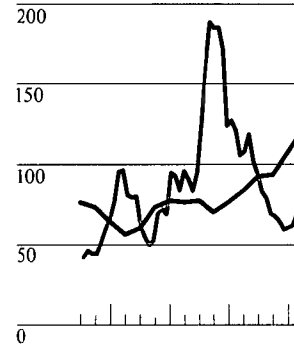
Peru



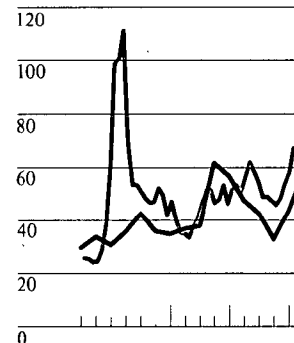
CPI

— Money supply

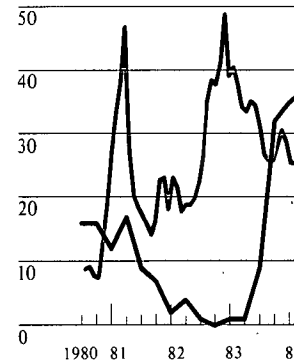
Brazil



Mexico



Philippines

^a Quarterly data; change over corresponding period of the previous year.

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programs will almost certainly push the 1984 and 1985 public-sector deficits above government forecasts. Likewise, pursuit of monetary discipline is complicated by inflationary expectations in the heavily indexed Argentine economy. Wage adjustments in excess of targeted inflation have already raised concerns in the IMF, which recently called for reductions in government spending, the money supply, and inflation. Inflation slowed somewhat in October and November, but recent monetary tightening may offer only a short respite to inflationary pressures.

- [redacted] the monetary expansion necessary to finance recent economic measures taken in Bolivia could push inflation to an annual rate of over 2,000 percent by yearend. Because of a recent dramatic decline in real wages (36 percent between December and August of last year), the government is under heavy pressure from labor unions to index wage increases to 100 percent of increases in the consumer price index.
- Mexico's money supply has increased 92 percent in the past year, and its public-sector deficit remains high. With this and the government's commitment to stem the decline in real wages, we expect Mexico City to be unable to meet its 1985 deficit target of 5.1 percent of GDP, or its inflation target of 35 percent.
- Brazil's attempts to tighten fiscal and monetary policies under its IMF accord have had little evident effect on inflation. Brazil's highly indexed economy and inflationary expectations are keeping inflation above 200 percent for the second successive year. The Embassy reports that fighting inflation has become the current military government's top economic priority, but some Brazilian analysts predict that the growth strategy of the civilian government scheduled to take office next year could boost inflation to 250 to 300 percent.
- With a growing budget deficit in **Peru**, the Embassy reports that the government is unlikely to meet its 1985 inflation target of 81 percent. After several years of declining living standards,

the Belaunde administration is reluctant to impose new austerity measures. This is especially true in light of upcoming presidential elections and recent labor unrest generated by Communist-dominated labor unions.

- In the **Philippines**, real GNP fell by 5.5 percent in 1984, [redacted] 25X1
[redacted] The ensuing economic hardship is likely to strengthen the Communist-backed insurgency in rural areas. The 1985 IMF inflation target of 20 to 25 percent is less than half the current level. The achievement of this goal depends heavily upon the impact of President Marco's health on Philippine political stability. [redacted] 25X1
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Implications

High inflation presents serious political and social challenges in several key LDCs. Inflationary psychology can undermine government efforts to resume the economic growth that will ultimately resolve debt problems by diverting investment from productive uses to speculative ventures and encouraging capital flight. IMF austerity programs could substantially alleviate these problems, but governments are wary of public reaction to the strong measures needed to control inflation. Negotiations on fund-supported economic programs are often contentious, and even the negotiated targets have been difficult to meet in the face of domestic pressures. A collapse of these fund programs could delay or halt IMF lending and imperil bank re-scheduling agreements to which they are linked. [redacted] 25X1

The inflationary spirals in Argentina and Bolivia present the greatest risk of prolonged economic chaos and increased political unrest. With money supply growth driving already severe price inflation to even higher levels, monetary discipline in these nations has been almost totally lost. In both countries, economic demands of powerful labor organizations significantly impede government attempts

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to devise viable austerity programs. Moreover, labor unions and other important economic players appear to have diminishing confidence that their governments have workable plans for reducing inflation. Other countries that face political and social fallout from inflation include Peru and the Philippines, where economic deterioration and political unrest reinforce each other, and Mexico, where social strains could intensify if living standards continue to fall.

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World Metal Prices: Still a Damper on LDC Earnings

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World metal prices, while likely to show more strength this year than in 1984, probably will continue to constrain export growth in several key LDC debtors. Jamaica's situation probably will be even worse than last year because of adverse aluminum market trends. Copper producers such as Chile, Zambia, and Zaire should do better, but even in these countries we do not expect marked improvements. Slower OECD economic growth, the absence of inflationary pressures, and further conservation and a continued shift to metal substitutes should prevent anything other than modest increases in prices of any metals this year.

upward pressure on prices. Moreover, high interest rates were a disincentive for inventory rebuilding.

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Response to Low Metal Prices

Producer responses to the low metal prices have varied widely. Producers in the OECD countries, particularly in the United States, have generally been sensitive to weak prices. As a result of higher production costs, capacities have been trimmed and production has fallen. For example, with US copper production costs more than 20 percent above world averages, few US producers could operate at a profit.

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A Disappointing Recovery for Metals

More than two years of economic recovery have done little to revive metal prices. After a modest 2-percent gain in 1983, metal prices¹ in 1984 dropped 13 percent.

In contrast, many cash-strapped LDCs maintained production despite low prices. In Chile, for example, where copper production costs are among the lowest in the world, profits were made even at the 1984 price level. Moreover, even in LDCs where production costs are high—and where low metal prices in 1984 should have dictated significant cutbacks—output was maintained because of revenue needs. This was especially true in Zaire and Zambia, which rely on copper earnings for 40 and 90 percent of their foreign exchange revenues, respectively.

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The factors behind the slide last year include:

- The strong US dollar, which rose by 13 to 20 percent against major European currencies last year, depressed the price of metals that are largely denominated in dollars.
- While much improved, demand has not rebounded as strongly as in previous recoveries. Capital investment has been held back by high real interest rates, and low-capacity utilization—especially in Western Europe—also retarded capital spending.
- Entering 1984, most metal markets were glutted. With stocks high, improved demand put little

Prospects for 1985

Metal markets enter 1985 in somewhat better condition. In general, inventories are leaner, production is more in line with demand, and metal usage should continue to increase. The perception

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¹ Overall price trends are based on the *Economist's* price index for industrial materials.

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Selected LDCs: Dependence on Mineral Exports, 1983

Country	Commodity	Estimated Mineral Export Earnings as a Share of Total Export Earnings (percent)
Chile	Copper, iron ore	50
Jamaica	Alumina, bauxite	65
Morocco	Phosphates	20
Peru	Copper, iron, lead, silver, zinc	50
Zaire	Cobalt, copper, diamonds	60 ^a
Zambia	Copper	90

^a Based on 1982 data.

of the "glutted market" is beginning to erode. Much will depend on the dollar. If the long-expected decline in the dollar begins, there could be substantial price gains in 1985. Even if the dollar remains at current high levels, we expect some recovery in at least two of the major markets:

- For the first time in five years, copper usage last year significantly exceeded production. Stocks were reduced from nearly 12 weeks of current consumption to about eight. Substantial cutbacks in productive capacities were also made during the year, particularly in the United States and the Philippines. Prices, however, should remain well below the peak levels of 1980 as the restart of idle capacities boosts supply. Additional supplies of copper are expected this year from Iran, Brazil, and Mexico, offsetting expected production cutbacks in the United States.
- Lead prices remained depressed in 1984, averaging just 20 cents a pound—about the same as in 1983 and 60 percent below their peak in 1979. Despite strikes in Australia and the United States, production remained unchanged, while lead usage increased by roughly 2 percent. Stocks fell 15 percent, equivalent to 6 weeks of current

World Metal Stocks

Thousand metric tons

	1980	1981	1982	1983	1984 ^a
Lead					
Stocks	525	518	559	541	460
Consumption days	49	50	54	53	43
Zinc					
Stocks	787	875	801	668	700
Consumption days	65	75	70	56	59
Copper					
Stocks	1,092	1,087	1,499	1,538	1,190
Consumption days	56	55	81	83	57
Aluminum					
Stocks	2,078	3,115	2,936	2,024	2,310
Consumption days	63	101	99	62	68
Tin					
Stocks	32,584	42,691	65,500	79,100	60,000
Consumption days	68	96	156	186	144

^a Estimated yearend totals.

consumption. Lead prices should show moderate increases in 1985. Inventories are relatively low, and demand seems likely to improve further with above average automobile demand.

The outlook in other markets is mixed:

- The weakness in aluminum prices last year resulted from premature reactivation of idle capacities in 1983, prompted by rapid price increases and a 10-percent pickup in demand. Since mid-1984, however, major producers in North America and

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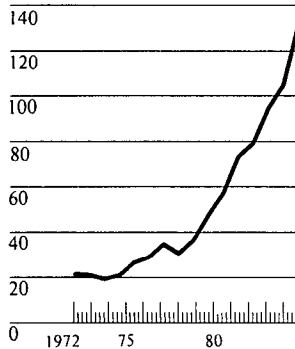
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World Metal Prices: Still a Damper on LDC Earnings, 1972-84

Note change in scales

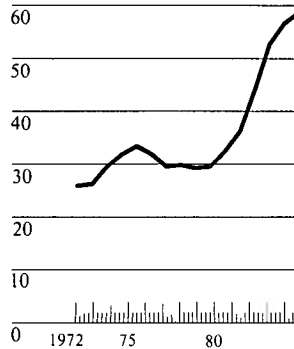
Copper

US cents per pound



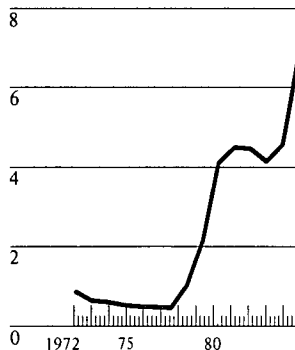
Lead

US cents per pound



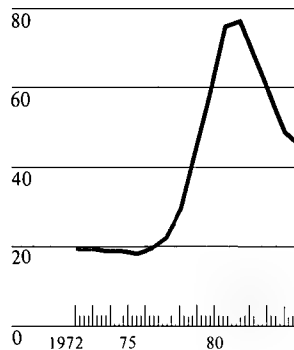
Tin

US \$ per pound



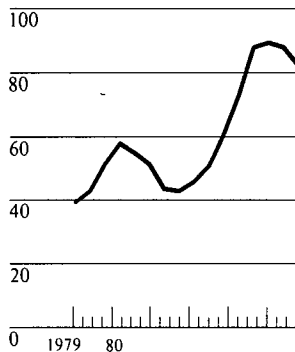
Zinc

US cents per pound



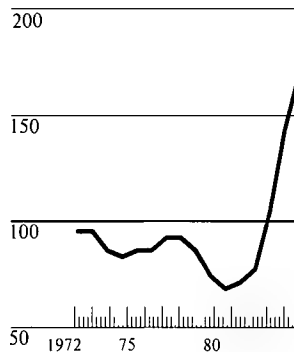
Aluminum^a

US cents per pound



Metals

Index: 1975=100



^a Average quarterly price on the London Metals Exchange.

Europe have been cutting back production. Further cutbacks are necessary for prices to rise significantly in 1985, as evidenced by the 300,000-ton buildup in stocks last year.

- Unlike most metals, zinc prices last year increased 20 percent over 1983 levels. The price rise was caused by a continuation of the buildup in industrial demand begun in 1983—particularly from the automotive sector—and heavy Chinese buying. Zinc prices will probably be little changed in 1985. Continued improvement in housing and automobiles will help prop up demand but this will be offset by growing output and a buildup in stocks.
- After nearly three years of International Tin Council (ITC)-imposed export quotas on producing members, tin consumption exceeded production for the first time since 1976, and stocks fell almost 25 percent. Nevertheless, the tin market remains greatly oversupplied, with commercial stocks totaling about 60,000 tons. Tin prices are expected to remain weak in 1985 because of slack demand, huge inventories, and increased production by non-ITC members, Brazil and China. The ITC will continue to prop up prices through export controls and buffer stocks purchases.

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Implications

The impact of improved metal prices on LDCs will vary widely. Chile should reap additional benefits in 1985 from recent expansion of its copper industry. The same is true for Zambia, which last year purchased new equipment that will increase productivity and lead to gains in output this year. Jamaica, on the other hand, will probably be worse off in 1985. Modest price gains in aluminum will be more than offset by fewer exports due to the closure of US Gulf Coast aluminum plants—Jamaica's major market for its bauxite.

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The modest price gains expected in 1985, although a considerable improvement over last year's poor performance, surely dashes the hopes of many metal-exporting LDCs, who had been expecting large increases in their minerals export earnings. If, as many economists predict, 1985 turns out to be the last year of recovery in the current business cycle, it could signal worse times ahead for metal producers.

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**Developing Countries:
Policies Toward
Foreign Direct
Investment**

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Most debt-troubled LDCs—fearing foreign economic control and seeking to protect domestic industries—have done little over the past several years to boost foreign direct investment as a source of economic growth. Despite a decline in commercial bank lending and official aid, a number of countries have taken measures that actually discourage foreign investors. Although some countries are taking steps to encourage foreign investment, we believe that most developing countries over the near term will avoid substantial policy shifts that promote foreign direct investment. Given the prospects for lagging economic growth, continuing foreign exchange problems, and political unrest, even substantial incentives would probably do little to improve the investment climate in many of these countries.

Recent LDC Actions

While few developing countries are actively working to attract new foreign direct investment, some countries, including key debtors, actually have taken actions discouraging to foreign investors:

- Mexico recently tightened controls over the manufacturing and marketing activities of foreign-owned automotive, electronic, and pharmaceutical firms, although a few exemptions continue to be granted for investment in export-oriented firms and to acquire new technology. For example, Ford late last year secured an agreement for a \$500 million assembly plant, receiving both financial incentives and an exemption from local ownership controls.
- Under an IMF-supported restructuring of the tax system, designed to increase revenues, the Philippine Board of Investment recently rescinded all tax and duty incentives given to regional headquarters of foreign companies—a move that

could encourage these firms to move their regional headquarters to Singapore and Hong Kong, which continue to grant such incentives.

- The elimination of tax holidays by Indonesia has led to an immediate decline in new investment applications, according to the US Embassy. A new law requiring unions in foreign-owned firms has led one company official to say he will recommend to corporate headquarters that plans for future investment be halted.

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On the other hand, several developing countries have recently taken steps to attract more foreign investment often through special incentives to channel new capital and technology into targeted areas:

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- South Korea revised its Foreign Capital Inducement Law in July to open up the computer and robotics industries to foreign participation, ease restrictions on remittances, and streamline the approval process for investments in which the foreign partner holds a minority share.
- Chile is attempting to reverse the 60-percent drop in foreign direct investment in 1983 by improving its already liberal investment policy, according to the US Embassy. For example, earlier this year a new mining code was enacted that places constraints on expropriation and gives foreign owners the same rights as natives to buy and sell mineral concessions.
- Although the five Andean Pact countries are formally bound by a treaty that establishes unified foreign investment regulations, Ecuador, Colombia, and Peru have recently relaxed these regulations to attract additional foreign capital.

Quito has eased profit repatriation and ownership rules; Bogota has offered tax breaks for export-oriented firms and liberalized controls on profit remittances; and Lima has doubled remittance allowances.

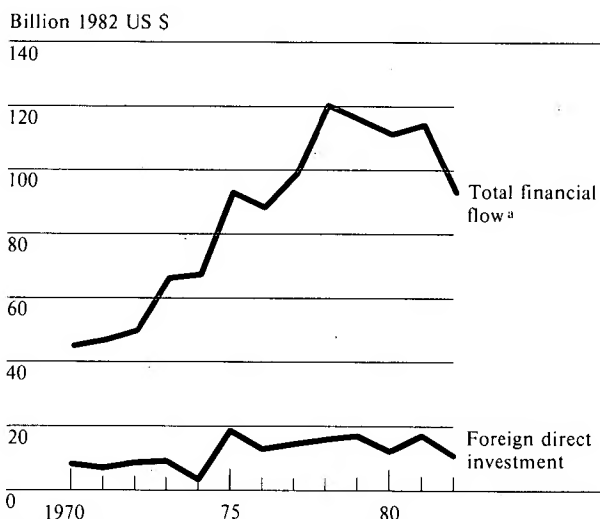
- A few others, including Jordan, Zaire, and Kenya, have approved or are considering measures to encourage new foreign ventures. [redacted]

Outlook

Over the near term, increases in foreign direct investment in most developing countries will continue to be limited by tight state controls and depressed economic conditions. We believe most developing countries will continue to be reluctant to encourage foreign direct investment on a substantial scale. Political concerns of foreign economic control or a desire to protect a domestic industry will continue to dominate the views of many of these countries. Moreover, the economic outlook of the country, exchange rate and trade policies, and political stability play an important role in the success or failure of investment incentives. In a country like Chile, for example, facing low economic growth, foreign exchange problems, and political unrest, even substantial incentives would probably do little to improve the overall investment climate.

Despite some hopes expressed for foreign direct investment to take up the slack from recent cut-backs in bank lending and other capital flows, there is little prospect for the role of foreign investment in LDC recovery. Since 1970, [redacted] foreign direct investment in developing countries has held steady at an average \$12 billion per year. Other financial flows, however, are down by

LDCs: Role of Foreign Investment, 1970-82



about \$20 billion from 1981 levels. Thus, it would take an unlikely tripling of foreign investment to merely offset the decline in these other sources of capital. [redacted]

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